

ICPS newsletter

Ukraine needs comprehensive public debt policy

Conditions for the recovery of the public borrowing market are economic growth, financial stability, and consistent government policies. In order not to repeat previous mistakes, the government should borrow within the framework of a long-term public debt strategy. The International Center for Policy Studies presents its view of the public debt policy in Ukraine in special chapter of the Quarterly Predictions journal. In our opinion, the government needs to accomplish the following tasks: formulate its policy regarding debt, set up a system of debt management, and develop the domestic capital market

Political and economic changes have raised the importance of developing a public debt strategy for Ukraine. We consider the following changes as the most important:

- Higher quality of budget policy. Firstly, a balanced budget confirms the government's intention to stop releasing uncontrolled loans. Secondly, the Finance Ministry has developed procedures for programmed and targeted budget expenditures that would ensure targeted use of the budget allocations and allow determining priority investment programs. Thirdly, medium-term budget planning will help keep track of government needs for financing.
- A closer focus of the monetary policy on lowering inflation and maintaining a stable exchange rate. To achieve these targets, the NBU needs a developed secondary government securities market, since in this case the bank would receive additional monetary policy instruments.
- Economic growth, financial stability, and consistent government policy. Under these conditions, commercial banks can free up resources and, therefore, can use government securities as an investment alternative. Moreover, under such conditions the government securities might become attractive for foreign investors.

Goals of public debt policy

The first step in the development of a public debt policy for Ukraine is to

formulate the policy goals. In our opinion, this policy should aim to improve social welfare by making a choice between the current and future government consumption:

- Changing the public debt allows maintaining the level of government expenditures in periods of cyclical recession.
- Government borrowings can be used as investments that would affect the welfare of different generations. Thus, future generations will both enjoy the fruits of the investments and have to repay the debts.
- A broader and deeper market of government securities would represent (1) an additional source of revenues for the private sector's free funds, (2) a market instrument of monetary policy, and (3) an indication of the domestic investment climate.

In our opinion, the Ukrainian government faces the following tasks: (1) develop and justify the public debt strategy; (2) create a debt management system; and (3) develop the domestic government securities market.

Policymaking

The government should issue and publicise a document that would analyse existing problems and justify the main long-term targets of debt policy. This document is an important condition for government credibility in the eyes of investors, since it would assure the transparency and predictability of

government behaviour with respect to the state debt. Moreover, a consistent public debt strategy would favour the approval of corresponding laws in the Ukrainian parliament.

Public debt management

The main goal of debt management is to meet the government's needs for financing and to repay its debts at a minimal cost in the medium and long run. In a broader sense, the goal is to ensure a stable dynamic and level of the public debt, for only in this case would the government be able to guarantee steady repayments under any economic conditions.

The debt management system can become effective only if the objectives and functions of the budget, monetary, and debt management policies are clearly determined.

In Ukraine, functions and responsibilities in the area of debt management have already been established de facto. The Finance Ministry develops debt policy, submits proposals on debt emissions to the Cabinet of Ministers, and issues orders on public debt repayment and servicing to the State Treasury. To this end, a public debt department has been established in the Finance Ministry, with its units being responsible for domestic and foreign debt management. Meanwhile, the NBU provides for the technical functioning of the government securities market, and the Accounting Chamber of Ukraine serves as an external controlling body.

The clear functions of this triangle, however, have not yet been legally determined. In our opinion, the distribution of responsibilities between the Finance Ministry and the State Treasury, as well as the independence of monetary policy from debt management

requirements will provoke the hottest debates.

Currently, the functions of debt policymaking and debt management are fulfilled by the public debt department of the Finance Ministry. This concentration of responsibilities allowed putting the public debt system in order. In the long run, the Finance Ministry will need to deal with more complicated tasks. These include the evaluation of investment programs which require external financing. On the other hand, once the system of debt management is established, further adjustments will be sooner technical than conceptual in nature. The more active the state borrowing policy, the more time workers of the Finance Ministry will need to allocate to technical issues, being forced to divert from the analysis of government needs for financing, i.e., accumulating new debts.

International experience proves that the most efficient systems are where the function of debt policymaking is granted to the Finance Ministry and the management of risks and expenditures, as well as the issue of debt and reimbursement of principal and interest payments, is fulfilled by the Treasury. The effective legislation of Ukraine envisions this same distribution of functions.

We see the following advantages in the distribution of policymaking and management functions between the Finance Ministry and State Treasury with respect to the public debt:

- The Finance Ministry focuses on determining and analysing priority programs: loans attracted to finance them would allow maximising the welfare of future generations.
- The State Treasury would manage both the monetary and debt flows of the government. With these powers, the Treasury will be fully responsible for government liquidity. It will manage all government assets and liabilities and will choose optimal borrowing strategies, based on the analysis of government assets. Combining these functions would require amending Ukrainian laws (this primarily concerns the right of the State Treasury to sell surplus funds in the inter-bank market) and developing the agency's capacity to fulfil these tasks. The main criterion for determining the

NBU's role in debt policy is independent monetary policy. The independence would remove inconsistencies between the targets of the monetary and debt management policies. One in particular is interest rates: lower rates would make the debt cheaper, while the central bank, willing to abate inflationary pressures, might find raising interest rates more expedient.

International experience proves that the government and the central bank should cooperate to prevent simultaneous moves in the same segments of the capital market. The coordination task becomes more complicated if the capital market is underdeveloped. If the moves are not coordinated, neither party is able to achieve its goals.

Development of the domestic capital market

An efficiently operating, liquid market of the domestic government debt would be beneficial for all potential agents of this market. For private investors, government securities (GS) are a source of risk-free revenue. A liquid GS market would ensure that monetary policy is independent of government needs for financing, because the NBU would no longer be the biggest lender to the government. Thanks to operations in the secondary GS market, the NBU would have more instruments with which to affect money supply. Finally, for the government, a developed GS market is a source of relatively cheap (thanks to its liquidity) loans.

Private investors will evince a demand for GS only under conditions of macroeconomic stability. Today, the balanced budget and stable exchange rate provide these conditions. The balanced budget signals the government's willingness to repay its debt. Meantime, facing a stable exchange rate, commercial banks have fewer profit opportunities in the FX market. However, high inflationary expectations leave little hope for a rapid recovery of demand for GS on the part of commercial banks. The return on medium-term GS is set equal to the targeted inflation rate, which the government has failed to accomplish in the past. As a result, the demand for short-term GS is higher than for medium-term ones.

A more liquid GS market would remove the effect of this factor, since banks would be able to sell their GS holdings. In our opinion, the liquidity of the market will depend on the market infrastructure, the availability of a variety of GS, and the number of investors. The Finance Ministry is undertaking the following steps to raise the liquidity of the GS market:

- A primary dealer's institution. The Finance Ministry and commercial banks have been preparing a relevant normative act, according to which only primary dealers who bid to buy no less than 2% of the GS emission will be able to participate in the GS sales auctions. Overall, primary dealers are to be the market makers, ensuring market liquidity by placing sales and purchase orders.
- Gradual introduction of GS with a longer term to maturity. Along with the traditional zero-coupon 4- and 7-month bills, the NBU floated coupon government bills from its portfolio. In addition, the Finance Ministry regularly offers 18-month bonds to market agents.
- Debt issues for individuals. In this way, the Finance Ministry aims to make the market broader.
- Transparency of domestic borrowing. For the first time, the ministry started collaborating with commercial banks, willing to establish partner relations with some of them. The ministry plans to place GS prices and auction results on its web site.

Both the Finance Ministry and the NBU consider the development of the GS market to be beneficial. This enhances the effectiveness of collaboration between the two institutions, especially after the government debt restructuring before the NBU in September 2000. A first, most fruitful result has been the removal of the reserve requirement imposed by the NBU on commercial banks' holdings of GS. Thanks to the REPO operations with the NBU's holdings of the restructured GS, the market started heating up. Yet, procedures of harmonising the tactic steps of the government and the NBU are not consistent or transparent. With the lack of transparency, any small inconsistency negatively affects market credibility in the eyes of the commercial banks. ■